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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1955

No. 605

PACIFIC AFFILIATE, INC., a corporation,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit.

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to the United States Court of Appeals
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PETITION.

The petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered July 20, 1955 in the above entitled proceeding, affirming the decision of the Tax Court of the United States relat-

ing to petitioner's income and excess profits tax liability for the calendar years 1943 and 1944.

OPINIONS BELOW.

The case was initiated in the Tax Court of the United States. The Tax Court opinion on one of the two questions (Question 2, infra) with respect to which the review by this Court is sought is reported in 18 Tax Court Reports 1175, at pages 1208 and 1209, and is set forth in the printed Transcript of Record pages 59 to 61. The Tax Court opinion on the other question (Question 1 infra) with respect to which the review by this Court is sought is reported as a Supplemental Opinion in 19 Tax Court Reports 245, which is set forth in full in the printed Transcript of Record pages 71 to 72.

The opinion of the U. S. Court of Appeals is reported in 224 Fed. (2d) 578 and is set forth in full for the convenience of the Court as Appendix B hereto.

JURISDICTION.

(i) The judgment of the U. S. Court of Appeals sought to be reviewed was dated and entered July 20, 1955 (R 241, Appendix C, infra).

(ii) Petition for rehearing on the questions here presented was duly filed August 8, 1955, and was denied December 1, 1955 (R 246).

(iii) Review by this Court is sought pursuant to authority contained in Section 7482 of the Internal Revenue Code of 1954 (26 USC Sec. 7482) and Section 1254(1) of the Judicial Code as amended (28 U.S.C. Sec. 1254(1)).

QUESTIONS PRESENTED.

This case involves the petitioner's excess profits tax liability for the calendar years 1943 and 1944.

Two questions are presented. Both relate to the computation of Invested Capital for excess profits tax purposes. The first question relates to the accumulated earnings and profits factor of Invested Capital (Section 718(a)(4) of the Internal Revenue Code of 1939 set out in Appendix A hereto) affecting the excess profits tax for 1944; and the second question relates to the borrowed capital factor of Invested Capital (Section 719(a) of the Internal Revenue Code of 1939 set out in Appendix A hereto) affecting the excess profits tax for the year 1943.

Question 1.

May an ultimate income and excess profits tax *deficiency* for the calendar year 1943, liability for which has been and is still in controversy in this litigation and not determinable in amount until this litigation is concluded, be related back as an expense and liability accrual on December 31, 1943 in determining the amount of the taxpayer's accumulated earnings and profits on December 31, 1943 which will be used

as a factor in computing the taxpayer's invested capital and excess profits tax liability for the year 1944.

Question 2.

Where a taxpayer incurs an indebtedness in a business transaction and agrees to pay part of the profit therefrom to a business associate who had rendered assistance to it, is it proper for the trial court either to conjecture without any support from the evidence that the indebtedness might not be entirely the indebtedness of the taxpayer and base its decision thereon; or to substitute as it did, an arbitrary amount in lieu of the full amount of the indebtedness as the allowance for borrowed capital to which the taxpayer is entitled under Section 719(a) of the Internal Revenue Code which provides that "borrowed capital" shall be "the amount of the outstanding indebtedness (not including interest) of the taxpayer".

STATUTES INVOLVED.

Sections 714 to 719 of the Internal Revenue Code of 1939. The pertinent text of these statutes is set forth in Appendix A to this Petition.

STATEMENT OF THE CASE.

Statement as to Question 1.

The Commissioner of Internal Revenue proposed a substantial deficiency of income and excess profits taxes against the petitioner taxpayer for the calendar

years 1943 and 1944. The petitioner appealed to the Tax Court of the United States contending it was not liable for this tax and that the Commissioner erred in a number of instances in the determination of the deficiencies. (Petition to Tax Court and Respondent's Answer to Petition R 4-24.) After the Tax Court opinion, and decision (R 83), sustaining the Commissioner as to some issues and reversing him as to others, both parties appealed to the U. S. Court of Appeals for the Ninth Circuit. (Petitioner's petition for review R 86-93.) The Appellate Court sustained the Tax Court on all points raised in the appeals. (Decision R 242; opinion attached hereto as Appendix B.) Petitioner's petition for rehearing, filed on August 8, 1955, was denied on December 1, 1955 (R 246). The petitioner taxpayer is now asking this Court to review the decisions below on two questions, one of which involves the petitioner's tax liability for the year 1943, and the other the petitioner's tax liability for the year 1944.

On its 1943 income and excess profits tax returns it reported an income tax of $87,353.25 and an excess profits tax of $288,154.10 (R 7-8 admitted in answer R 17) or a total of $375,507.35. The recomputed tax according to the Tax Court decision is an income tax of $136,343.34 and an excess profits tax of $544,344.26 (R 74), or a total of $680,687.60, or a deficiency of $305,180.25 over the amount originally reported. At the present stage of these proceedings the petitioner's tax liability for 1943 is still in dispute and is subject to possible change by action of this Court on this peti-

tion. The Courts below decided (R 71-72; Appendix B hereto) that notwithstanding this dispute, the 1943 tax deficiency when finally determined must be considered as though it were fixed and determined on December 31, 1943, and must be recognized as an accrued expense and liability as of that date, reducing the accumulated earnings and profits up to that date allowable as invested capital for 1944 under Section 718(a)(4) of the Internal Revenue Code of 1939.

Accumulated earnings and profits up to December 31, 1943 is one of the factors making up the invested capital for the year 1944. The excess profits tax credit for 1944 is a certain percentage of invested capital. Thus, by reducing accumulated earnings and profits, the invested capital and the excess profits credit is reduced, with a consequent increase in income subject to excess profits tax and increase in the amount of the 1944 excess profits tax.

Petitioner taxpayer contends that it is well established by decisions of this Court, that the amount of the disputed 1943 tax deficiency cannot be accrued as a liability or expense until definitely fixed at the conclusion of the dispute, and will not reduce earnings and profit until the accounting period in which the amount of such deficiency is determined and fixed; and therefore the Courts below erred in relating the deficiency back as though it were fixed and determined on December 31, 1943.

Statement as to Question 2.

Borrowed capital is another one of the factors making up the invested capital, and is defined in Section 719(a)(1) of the 1939 Internal Revenue Code as

> "The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note . . ."

In 1943 the petitioner taxpayer made two borrowings evidenced by its notes, one from the Guaranty Trust Co. of New York, and one from the Bank of America N.T. & S.A., to finance a business transaction. Petitioner agreed to pay, and did pay, to a business associate some of the profits realized on the transaction. In concluding that the petitioner was entitled to use only 50% of the loans as borrowed capital, the Tax Court, whose decision on this point was affirmed without opinion by the Appellate Court, said (R 60-61):

> "Respondent has allowed 50 per cent of the indebtedness so incurred by petitioner as borrowed invested capital until November 16, 1943, and 100 per cent thereafter. He argues, on brief, that '* * * Where monies are borrowed in a joint venture or enterprise the borrower is not entitled to include in invested capital borrowing in excess of his interest in the venture'. On the record, we believe respondent made a correct determination."

Neither the Record nor the Statute (Section 719) support this conclusion or determination.

It is not clear whether the Tax Court based its conclusion on the fact that taxpayer was sharing some of the profit, or on its conjecture that (R 61):

> "Albeit petitioner made the purchase of bonds in its own name, the arrangement supporting the purchase and the manner in which petitioner handled the transaction on its books, convince us that Blair was more than a passive recipient of the benefits of the deal, and, had occasion arisen to present the question, Blair would have been held to account for a 50% responsibility in the loans and purchases, not only in the profits. Since each case turns on the particular facts appearing, and since no two cases present identical facts, we get little help from the cited cases. We sustain respondent's action in respect to this item."

To the extent the Court's decision is based on the conclusion that there is discretionary authority to allow an amount less than the amount of the indebtedness the Tax Court erred in that the Statute (Sec. 719) is specific that it is the *full* amount of the borrowings which must be recognized as borrowed capital. The statute does not authorize the fixing of an arbitrary lesser amount, and the sharing of the profits is immaterial to the determination of the borrowed capital allowance. To the extent the decision is based on the conclusion that the entire indebtedness was not the indebtedness of the taxpayer, the Tax Court erred in that there is absolutely nothing in the record to justify such a conjecture or hypothesis, and in fact the record affirmatively establishes that the indebtedness was entirely that of the petitioner. The facts were

stipulated and appear in pages 141 to 150 of the Record and were incorporated in the Tax Court's findings of facts (R 32-37).

Jurisdiction of Court of first instance.

Jurisdiction was conferred upon the Tax Court of the United States by Section 272(a) of the Internal Revenue Code of 1939 (Title 26, U.S.C. Section 272(a), now Section 6213(a)). The Commissioner's deficiency notice was dated December 6, 1946 (R 4, paragraph 2 admitted in Answer R 17). The Petition to the Tax Court was filed within 90 days thereafter on January 7, 1947 (R 1).

Jurisdiction was conferred upon the U.S. Court of Appeals for the Ninth Circuit by Sections 1141 and 1142 of said Internal Revenue Code (Title 26 U.S.C. Sections 1141 and 1142, now Sections 7482 and 7483). The decision of the Tax Court was entered May 15, 1953 and petitioner filed its Petition for Review within three months thereafter on August 14, 1953 (R 3).

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

As to Question 1.

In deciding that the ultimate determination of the amount of this taxpayer's income and excess profits tax liability in this proceeding for the year 1943 should be related back as though it were determined and accrued on December 31, 1943 for the purpose of computing this petitioner taxpayer's excess profits tax

liability for 1944, *the decision is directly in conflict with decisions of this Court in the cases of Lewyt Corporation v. Commissioner,* 349 U.S. 237, 75 S.Ct. 736 (decided May 23, 1955), *Dixie Pine Products Company v. Commissioner of Internal Revenue,* 320 U.S. 516 (decided January 3, 1944), and *Security Flour Mills Co. v. Commissioner of Internal Revenue,* 321 U.S. 281 (decided February 28, 1944), which cases hold that taxes in controversy do not accrue as a liability or expense until the controversy is determined, and the amount to be recognized as having accrued at the end of the year to which the tax relates cannot be changed by the changes which might occur at a later time by reason of the controversy.

As to Question 2.

In denying recognition as taxpayer's borrowed capital the full amounts which it owed to Guaranty Trust Co. of New York and to Bank of America N.T. & S.A. on the conclusion that the taxpayer petitioner was not indebted for such amounts, *the decision of the Court of Appeals has so far sanctioned a departure by the Tax Court from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision,* in that it violates the well recognized rule of law and judicial proceeding that the trial Court cannot substitute its own construction of the facts contrary to the evidence, nor can the trial Court ignore the evidence and base its decision upon a mere conjecture or hypothesis of what the facts might have been under a hypothetical situation and an assumption that those were the facts.

There is not only no support in the record for the conclusion of the Courts below that the indebtedness in question was not entirely the indebtedness of petitioner but the record definitely establishes that the petitioner taxpayer alone was liable for the full amount of the indebtedness.

Furthermore, the decision of the Courts below to the effect that an arbitrary allowance may be made for borrowed capital in an amount less than the amounts for which the taxpayer is indebted, *decides an important question of federal law which has not been but should be settled by the Court,* in that the Statute (Section 719(a)(1) of the Internal Revenue Code of 1939) is unequivocal in its requirement that borrowed capital shall be "the amount of the outstanding indebtedness (not including interest) of the taxpayer" and does not permit of an interpretation which would authorize the trial Court to determine an arbitrary allowance in lieu of the full amount of the outstanding indebtedness of the taxpayer.

Argument relating to Question 1.

In the presentation of the issue involved in this question the parties stipulated before the Tax Court as follows:

> "In computing invested capital for 1944 the correct income and excess profits tax liability for 1943 shall be taken into account as an accrued liability as of December 31, 1943, and the correct post-war refund of excess profits taxes for 1943 shall be taken into account as an accrued receivable as of December 31, 1943; if as a matter of

law they must be accrued as of December 31, 1943." (R 105).

It is now a well established principle of tax law that

> "a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent, and this principle is fully applicable to a tax, liability for which the taxpayer denies, and payment whereof he is contesting." (*Security Flour Mills v. Commissioner of Internal Revenue* (1944) 321 U.S. 281.)

The Courts below are of the opinion that this principle is applicable only if the item to be accrued is a deduction from, or an inclusion in, taxable income, as distinguished from an accrual of income and excess profits taxes which are not deductible in computing taxable income, and further that the rule is inapplicable in determining "accumulated earnings and profits" at the beginning of an excess profits tax year for invested capital purposes. Of course, even a deductible item, such as an excise or State tax, has an ultimate effect on accumulated earnings and profits, and certainly an anomalous situation would be created if a finally determined excise tax deficiency must be related back to determine accumulated earnings and profits at an earlier date, and then is again recognized in the form of a tax deduction affecting earnings and profits of the later period in which it was finally determined in amount.

There is no basis for the distinctions drawn by the Courts below. The above quoted rule as stated by this

Court draws no such distinction. The applicable principle has to do with the question of when a transaction is closed or completed for tax purposes, so that its final determination can be given effect in the proper accounting period; it has nothing to do with the nature or deductible character of the item or the transaction out of which it arose. It is predicated on the annual accounting concept for reporting income and expenses, and whether the income is taxable, or nontaxable, and the expenses are deductible or nondeductible, has nothing to do with the particular period in which they must be reported and to which they must be related. (*Dixie Pine Products Co. v. Commissioner of Internal Revenue* (1944), 320 U.S. 516.)

In the case of *Chestnut Securities Co. v. U. S.*, 62 F. Supp. 574 the Court of Claims described the rule of the above cases to be

> "One is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded."

This rule was applied by the U.S. Court of Appeals for the Seventh Circuit in the case of *Campana Corp. v. Commissioner of Internal Revenue* (1954), 210 F. (2d) 897 in denying the right of a taxpayer to relate back to a base period year a refund of a contested tax to increase the excess profits tax credit computed under the base period income method.

The Court below was of the opinion that this Court's decision in the case of *Lewyt Corporation v. Commis-*

sioner, 349 U.S. 237, 75 S.Ct. 736, decided May 23, 1955, involved only a construction of Section 122(d)(6) of the Internal Revenue Code and could not be cited as authority for any other situation. Yet, it does appear that in that case this Court took particular care to point out—

> "Finally, the tax that 'accrued' within a given year is not the tax finally determined to be due but the tax before ultimate adjustments are made. That is elementary in tax law. See *Security Flour Mills Co. v. Commissioner* 321 U.S. 281, 284. It would seem therefore that the concept 'accrued' embodies the accrual accounting principle. If, in case of a taxpayer on an accrual basis, events after the taxable year are taken into account, the word 'accrued' would be effectively read out of Section 122(d)(6) or given a varied meaning, contrary to our ruling in the Olympic Radio case."

In the *Lewyt* case the Government argued much the same as it argues here. It contended that the tax law and accounting rules announced by this Court in the *Dixie Pine Products Co.* and *Security Flour Mills* cases were not applicable to the determination of when an excess profits tax accrued for purposes of Section 122(d)(6). The Government argued that the later adjustment for a carry-back loss from a later year, reducing the excess profits tax should be related back to the year for which it was imposed and only the reduced amount be considered as the amount accrued as of the end of that year. In the *Lewyt* case and the *U. S. v. Olympic Radio and Television, Inc.* case de-

cided May 23, 1955, 349 U.S. 232, 75 S.Ct. 733, this Court pointed out that the rule of tax law that later adjustments of a disputed tax are not to be related back as an accrual in the year for which the tax was imposed, *applies to all sections of the tax law which involve the determination of accrual items,* unless the law directs otherwise.

In the *Lewyt* case the amount of accrual of excess profits tax was important *not* for the purpose of determining its deductibility but for the purpose of determining one of the factors to be used in arriving at a deduction classified as the "net operating loss deduction", which in turn is a factor in the computation of the final tax liability. In the instant case the amount of accrual of excess profits tax is important *not* for the purpose of determining its deductibility but for the purpose of determining accumulated earnings and profits, one of the factors to be used in arriving at invested capital and the excess profits tax credit, which in turn is a factor in the computation of the final excess profits tax liability.[1] So, in each case, the accrued excess profits tax is merely a factor in a formula for the computation of the ultimate tax. There is therefore no ground for distinction between them as to the applicability in principle of the general tax law rule that an expense or liability for a contested item does not accrue until the contest is settled. The Court of Appeals erred, therefore, in its decision

[1]Under Section 23(c)(1)(A) and (B) of the Internal Revenue Code of 1939, the excess profits tax is *not* an allowable deduction in computing taxable net income.

that the *Lewyt* case was distinguishable and was not applicable to this case.

The petitioner taxpayer in this case kept its records and filed its tax returns on an accrual basis of accounting (R 27).

In Treasury Department Regulations 112 Section 35.718-2 (set out in Appendix hereto) it is provided that the "concept of 'accumulated earnings and profits' for the purpose of the excess profits tax is the same as for the purpose of the income tax"[2] and "in computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year." Under the income tax concept and under the above cited decisions of this Court, the amount of the income and excess profits taxes to be "subtracted" can be only the amount accrued at the end of the previous year which according to the *Lewyt* case is the amount disclosed by the returns for the previous year and not the adjustments determined in a later year.[3]

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[2]See Treasury Regulations 111, Section 29.115-3 and 29.115-12—Appendix A infra, R. M. Weyerhaeuser, 33 BTA 594, 597.

[3]In Rev. Ruling 55-28 Int. Rev. Bul. No. 3, Jan. 17, 1955, p. 65, the Internal Revenue Service in construing Section 35.718-2 of Regulations 112 ruled that "accumulated earnings and profits must be decreased by the amount of accrued Federal income and excess profits tax liability for the preceding taxable year, computed on the basis of income as adjusted under section 22(d)(6) of the Code, and without benefit of any net operating loss or unused excess profits credit carry back". This ruling in not requiring the tax to be adjusted for carry backs is supported by the *Lewyt* decision, supra, but in requiring that the tax must be adjusted for inventory liquidation adjustments the ruling appears to be in conflict with

One of the questions in the *Lewyt Corporation* case in the Appellate Court (Court of Appeals for the Second Circuit) which was not reviewed by this Court was whether excess profits tax deficiencies in dispute for the years 1943, 1944 and 1945 accrued prior to the time of settlement of the dispute in 1948. The Appellate Court decided (215 F(2d)518) ". . . it is clear that none of these excess profits taxes had accrued prior to 1947 because they were in dispute—see *Dixie Pine Products Co. v. Commissioner,* 320 U.S. 516."[4] The decision of the Court of Appeals for the Ninth Circuit in the instant case is directly in conflict with the Second Circuit's view as to the general applicability of this Court's decision in the *Dixie Pine Products Co.* case.

It is respectfully submitted that the rule of tax law and of accounting practices that later year adjustments of a disputed tax cannot be related back as an accrual at the end of the year for which it is imposed, is of general application to the Internal Revenue Code, and the Appellate Court erred in refusing to apply it in this case, *and its decision is therefore*

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the *Lewyt* decision. In the *Lewyt* decision one of the adjustments of income for 1944 resulted from renegotiation, yet this Court did not require that the tax accrued for 1944 be reduced by the refund resulting from the renegotiation adjustment. There is no difference in principle as to the effect of either type of adjustment on the tax which accrued at the end of the tax year.

[4]The issue presented on this point was whether the tax accrued in 1947 when "payment" was made, or in 1948 when the controversy was settled and the payment applied by the Collector to the tax. The Court of Appeals held that the tax deficiencies accrued in 1948. The taxpayer asked for certiorari on this point as well as on the points as to which certiorari was granted, but its request was denied.

in conflict with the decisions of this Court in the following cases:

Security Flour Mills Co. v. Commissioner, 321 U.S. 281;

Dixie Pine Products Co. v. Commissioner, 320 U.S. 516;

Lewyt Corporation v. Commissioner, 349 U.S. 237;

U. S. v. Olympic Radio and Television, Inc., 349 U.S. 232.

Argument relating to Question 2.

The facts with respect to which this question arises were stipulated in the trial Court and appear in the printed Transcript of Record, pages 141 to 148, and were also incorporated in the Tax Court's Findings of Fact (R 32-37), as follows:

Just prior to April 16, 1943, Blair Securities Co., a business associate of the petitioner who was assisting the petitioner in expanding its Government bond dealer business, suggested that petitioner make an original subscription for $20,000,000 of 2% U. S. Treasury Bonds which were about to be issued. Blair also stated that it thought it could arrange a loan to the petitioner from the Guaranty Trust Co. in New York at a favorable interest rate to carry the purchase.

On April 16, 1943, the petitioner made a subscription to $20,000,000 U. S. Treasury Bonds, 1950-1952, to the Federal Reserve Bank through the Bank of America N. T. & S. A. The Bank of America carried the obligation for the subscription from April 16 to

April 19, making an interest charge of $1,630.50 therefor computed at the rate of 1%. In the meantime Blair arranged a loan for the petitioner from the Guaranty Trust Co. for $19,800,000 to carry the bonds, at an interest rate of ¾%.

This loan was made to petitioner on April 19 upon petitioner's execution and delivery to the Guaranty Trust Co. of its promissory note. On that date petitioner also paid to Guaranty Trust Co. $200,000 cash which it withdrew from its margin account at Bear Stearns & Co. On the same day Guaranty Trust Co. paid the proceeds of the loan and the said $200,000 cash, or a total of $20,000,000 to the Federal Reserve Bank and thereupon received the said U. S. Bonds to be held as collateral security for said loan.

Between April 19, 1943 and May 14, 1943, the petitioner made sales of these bonds finally disposing of the entire $20,000,000 of bonds. It paid interest to the Guaranty Trust Co. for this period in the amount of $9,225.47. It paid to the Bank of America on open account for the period April 16 to April 19, interest in the amount of $1,630.50, as aforesaid, making a total interest payment of $10,855.97. It collected interest income of $27,010.84 making a net amount of interest received over interest expense of $16,154.87, one-half of which, or $8,077.44, was paid by Bankamerica Co., the petitioner, to Blair Securities Co. The petitioner's letter dated May 20, 1943, transmitting its check to Blair Securities Co., 44 Wall Street, New York, read as follows:

> "We enclose our check payable to you for $8077.44 which is one-half the net interest earned

on the $20,000,000 U. S. Treasury 2% Bond account.

"There is also enclosed an itemized statement of this account."

The itemized account referred to in the foregoing letter was as follows:

INTEREST ACCOUNT

$20,000,000 U. S. Treasury—2% Bonds—9/15/52/50

Interest Earned:		
4/15 to 5/ 7/43 on $6,000,000	$7,173.90	
4/15 to 5/10/43 on 3,000,000	4,076.10	
4/15 to 5/12/43 on 3,000,000	4,402.17	
4/15 to 5/13/43 on 3,000,000	4,565.22	
4/15 to 5/14/43 on 5,000,000	7,880.45	
Total Interest Earned		$28,097.84
Less: Interest paid		
1 day accrued interest 4/15 to 4/16 on purchase	$1,087.00	
Interest at 1% from 4/16 to 4/19 on $20,000,000	1,630.50	
1 day interest at 3/8% on $20,000,000 for Fed. funds	208.33	
Interest at 3/4%		
4/19 to 4/20 on $20,000,000	416.66	
4/20 to 5/ 7 on 19,800,000	7,021.39	
5/ 7 to 5/10 on 13,860,000	866.23	
5/10 to 5/12 on 10,890,000	453.74	
5/12 to 5/13 on 7,920,000	165.00	
5/13 to 5/14 on 4,950,000	103.12	
Total Interest Paid		11,942.97
		$16,154.87

DISTRIBUTION

½ Blair Securities Company	$ 8,077.44
½ Bankamerica Company	8,077.43
	$16,154.87

On its books petitioner maintained a special account with Blair Securities Co. for the above-mentioned transactions. In that account it made monthly charges for fifty per cent of the interest paid to the banks for carrying the bonds and every few days entries were made crediting to the accounts interest at the coupon rate which accrued on fifty per cent of the bonds. A summary of the entries is as follows:

Interest on one-half of the loan to carry the bonds—charged monthly	$ 5,427.98
Interest on one-half of the bonds credited to Blair Securities every few days	13,505.42
Balance paid to Blair Securities Co.	$ 8,077.44

The Blair Securities Co. acknowledgment dated May 26, 1943, reads as follows:

> "This will acknowledge your letter of the 20th addressed to Mr. Wood, enclosing your check for $8,077.44 representing one-half of the net interest earned on the $20,000,000 principal amount—U. S. Treasury 2% bond Account.
>
> We also acknowledge your itemized statement covering this account."

The petitioner in addition to realizing the net interest profit of $8,077.43, realized a profit from the sales of the bonds in the total amount of $41,875.00, which profit was reported by it as ordinary income resulting from the operation of its dealer business.

In September the Treasury again issued bonds and again Blair Securities Co. and petitioner agreed to a transaction similar to the one in April, but this time the arrangement differed in that the agreement pro-

vided for the sharing of profits on the bonds. The petitioner made the subscription for $20,000,000 of bonds under date of September 15, 1943, through the Bank of America N. T. & S. A. at San Francisco. It paid $200,000 cash and borrowed $19,800,000 from the said Bank on its promissory note. Blair Securities Company paid $100,000 to the petitioner to be used in making the $200,000 cash payment above mentioned. When petitioner received this $100,000 from Blair, it recorded the receipt on its books by crediting $100,000 to its Blair Securities Corporation account. The item remained in this account until the petitioner repaid it on November 16, 1943, as hereinafter stated. The bonds purchased as herein described were U. S. Treasury 2% Bonds 9/15-53-51.

On November 16, 1943, $10,000,000 of the par value of these bonds were sold to the Bank of America at a profit of $9,375.00. On the same day the petitioner authorized the Bank to credit $100,000 of the proceeds of said sale to the account of Blair Securities Corporation and on its books the petitioner charged the aforementioned Blair Securities Corporation account with this amount, wiping out the $100,000 previously credited to said account as hereinabove explained. Interest earned on the $20,000,000 of bonds to this date was $68,131.80 and interest paid on the $19,800,000 at this date at 1% per annum was $34,100.12, making a net interest return of $34,031.68. Bankamerica Co. wanted to close the joint account and to carry the remaining $10,000,000 of bonds free of its arrangement with Blair so it settled the joint

account by paying Blair one-half of the net interest earned of $17,015.84 and also the entire profit on the sale of the $10,000,000 of bonds on November 16, or $9,375.00, making a total of $26,390.84, and it sent its check for this amount to Blair Securities Co. on November 18, 1943. The Company's letter transmitting its check to Blair Securities Co., 44 Wall Street, New York, read as follows:

> "We are pleased to enclose our check for $26,390.84, representing your share of the interest earned and profit in the $20,000,000. United States Treasury 2% Bonds Joint Account.
>
> There is also enclosed an itemized statement of the Account."

The itemized statement referred to in the above letter was as follows:

JOINT ACCOUNT

$20,000,000 United States Treasury 2% Bonds, 9/15/53/51

Interest Earned:	
9/15/43 to 11/16/43 at 2%	$68,131.80
Less:	
1% interest on note $19,800,000 9/15/43 to 11/16/43	34,100.12
Net Interest Earned	$34,031.68
One-half net interest earned	$17,015.84
3/32 profit and sale $10,000,000 par value bonds	9,375.00
Due to Blair Securities Corporation	$26,390.84

On its books petitioner maintained a special account with Blair Securities Co. for the above-mentioned transactions. In that account it made monthly charges for fifty per cent of the interest paid to the

banks for carrying the bonds and every few days entries were made crediting to the account interest at the coupon rate which accrued on fifty per cent of the bonds.

The acknowledgment from Blair Securities Co. dated November 26, 1943, read as follows:

> "We acknowledge with thanks your letter of November 18 enclosing your check for $26,390.84 representing our share of earned interest and profit on $20,000,000 principal amount—U. S. Treasury 2s Due 9/15/53/51."

The taxpayer company sold $2,000,000 of the $10,000,000 remaining bonds to the Bank of America on November 17, 1943, at a profit of $2,187.50; it sold $2,000,000 of these bonds to J. C. Devine & Co. on November 17, 1943 at a profit of $2,500.00; it sold $1,000,000 of these bonds to J. C. Devine & Co. on November 18, 1943 at a profit of $1,250.00; and it sold $5,000,000 of these bonds to Bank of America on November 24, 1943 at a profit of $6,250.00. All of these profits were reported as ordinary income from the operation of the dealer business.

There is no writing about these transactions other than those hereinabove mentioned. The officials of the two companies had telephone conversations almost every day, so whatever details had to be taken care of were arranged over the telephone, but *there was no other agreement as to the general nature of the transaction than the agreements hereinabove mentioned* (R 147).

The Tax Court whose decision on this issue was affirmed by the Appellate Court without opinion concluded as follows (R 60-61):

> "Respondent has allowed 50 per cent of the indebtedness so incurred by petitioner as borrowed invested capital until November 16, 1943, and 100 per cent thereafter. He argues, on brief, that '* * * Where monies are borrowed in a joint venture or enterprise the borrower is not entitled to include in invested capital borrowing in excess of his interest in the venture.' On the record, we believe respondent made a correct determination. Albeit petitioner made the purchase of bonds in its own name, the arrangement supporting the purchase and the manner in which petitioner handled the transaction on its books, convince us that Blair was more than a passive recipient of the benefits of the deal, and had occasion arisen to present the question, Blair would have been held to account for a 50 per cent responsibility in the loans and purchases, not only in the profits. Since each case turns on the particular facts appearing, and since no two cases present identical facts, we get little help from the cited cases. We sustain respondent's action in respect to this item."

The record is clear that the petitioner taxpayer alone purchased the bonds, and that the petitioner taxpayer alone made the loans and signed the notes evidencing the loans. Furthermore, the stipulation is specific that there was no other agreement as to the general nature of the transaction than the agreements mentioned in the stipulation. There is no agreement mentioned in the stipulation which provides that anyone other than

the petitioner taxpayer should be liable for the loans made to the petitioner tavpayer.

Furthermore, the record is clear that the petitioner's net retention of gains from these transactions was greater than 50 per centum (R 144, 145, 147, 148) *so the allowance of only 50% of the loans as borrowed capital is purely arbitrary.*

Whether the business transaction for which the money was borrowed was a joint venture or whether petitioner shared its profits with Blair in appreciation of the assistance which Blair had rendered it, is immaterial to the question of whether Petitioner is entitled to treat the indebtedness in full as its borrowed capital. The only criterion specified by the clear and precise statute (Section 719(a)(1)—Appendix hereto) is that the indebtedness be the indebtedness of the taxpayer evidenced in a certain manner. Here the indebtedness was evidenced by a note, as required by the statute, and since it is the "indebtedness of the taxpayer", there can be no basis whatever for denying the taxpayer the right under the Statute to include it as borrowed capital.

As to whether this indebtedness was the indebtedness of the taxpayer, note the wording of the stipulation in describing the stipulated facts — "In the meantime Blair arranged a loan for the petitioner from the Guaranty Trust Co."—"this loan was made to petitioner upon petitioner's execution and delivery to the Guaranty Trust Co. of" its note (R 142); the journal entry recording the transaction on petitioner's

books shows the entire loan recorded as notes payable with the explanation that it represented moneys which "we borrowed" (R 142, 149); and as to the second transaction the "petitioner" * * * "paid $200,000 cash and borrowed $19,800,000 from the said Bank on its promissory note". (R 145.) And then to avoid any conjecture as to whether there was any other understanding about this arrangement than was recited in the stipulation, it was specifically stipulated that "there was no other agreement * * *" (R 147). If in fact a party to a joint venture is the purchaser of property to be used in the venture and is the sole obligor for the purchase price, as in this case, his participation in the venture cannot alter his position as purchaser and sole obligor (*Samuel L. Bramer* 6 R 1027, *E. L. Connelly* 46 BTA 22).

Even the Courts below hesitated about making an outright statement that this indebtedness was not the indebtedness of the taxpayer. The Tax Court's statement—apparently approved by the Appellate Court, was that it was convinced that "*had* occasion arisen to present the question, Blair would have been held to account for a 50 per cent responsibility in the loans and purchases, not only in the profits." (Italics added.) The Tax Court is resolving a purely hypothetical situation which is immaterial to the issue if in 1943 the indebtedness in question was the indebtedness of the taxpayer. If the Court's statement is to be construed to mean that it was its conclusion that the indebtedness was not the indebtedness of the taxpayer

then the statement is entirely without foundation and is contrary to the stipulated facts.

The Courts below seemed to be concerned about equitable considerations against permitting use of the full amount of the loans as borrowed capital where only a part of the profits on the transaction would be included in excess profits tax income. However, as between the Government on the one hand, and the taxpayer on the other, there is no inequity because under the Statute, only the taxpayers indebted can have the allowance of the loan as borrowed capital. In this case obviously Blair could not claim any allowance because the indebtedness was not its indebtedness. Only the petitioner taxpayer could secure the allowance of the loan as borrowed capital so there could be no possibility of the indebtedness being allowed more than once as borrowed capital. Furthermore, the borrowed capital allowance under Section 719 is in no wise dependent upon the amount of profit realized in the transaction for which the money was borrowed.

In summary, the effect of the decision of the Courts below as to Question 2 is, first, a construction of Section 719(a)(1) of the Internal Revenue Code of 1939 as though it permits the allowance for borrowed capital to be discretionary up to the full amount of the indebtedness of the taxpayer and second, a substitution of a conjecture on the part of the Courts below of what might have occurred in a hypothetical situation, for the facts at a given time as established by the record of the case.

As to the Court's construction of Section 719 it is respectfully submitted that if the indebtedness is a business indebtedness of the taxpayer evidenced by notes, as it was in this case, then the Statute requires that the taxpayer be allowed the full amount of that indebtedness as borrowed capital, and there is no authority for making the allowance in any other amount. *This question of whether there is any authority under Section 719(a)(1) for allowing anything other than the full amount of the taxpayer's indebtedness as borrowed capital is an important question of federal law which has not been but should be settled by this Honorable Court.*

As to the trial Court's conclusion that the indebtedness was not the indebtedness of the taxpayer, the Courts below erred in that such conclusion was not only not supported by the record but is contrary to the facts as set forth in the record and in the Tax Court's findings of fact; *and in approving the trial court's conclusion the Appellate Court so far sanctioned a departure by the trial court from the axiomatic and accepted rule and course of judicial proceeding that a trial court may not substitute its own opinions in place of the facts as established by the Record,*[5] *that the exercise of this Court's power of supervision is called for to correct the mistake and prevent an injustice.*

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[5] *Interstate Commerce Commission v. Louisville & Nashville R. Co.*, 227 U.S. 88, 91; *Wilson v. U.S.*, CA-8, 1942, 131 F.(2d) 301, 304; *Norfolk National Bank of Commerce and Trusts v. Commissioner*, CA-4, 1933, 66 F.(2d) 777, 780; *Simeon Sharaf v. Commissioner*, CA-1, 1955, 224 F.(2d) 570.

CONCLUSION.

Petitioner respectfully submits that the Court below erred in its decisions on the two questions presented herein, and therefore, for the reasons and on the grounds herein stated, petitioner respectfully requests that this Court grant this petition and issue its writ of certiorari.

January, 1956.

Respectfully submitted,

GEORGE H. KOSTER,
300 Montgomery Street, San Francisco 4, California,
Counsel for Petitioner.

(Appendices A, B and C Follow.)

Appendix A

STATUTES AND REGULATIONS INVOLVED.

Statute Involved.

Internal Revenue Code:

Section 714—Excess Profits Credit—Based on Invested Capital—

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, under Section 715 is:

	—the credit shall be
Not over $5,000,000	—8% of the invested capital
Over $5,000,000 but not Over $10,000,000	—$400,000, plus 6% of the excess over $5,000,000
Over $10,000,000	—$700,000, plus 5% of the excess over $10,000,000

Section 715—Definition of Invested Capital

For the purposes of this subchapter, the invested capital for any taxable year shall be the average invested capital for such year, determined under Section 716, reduced by an amount computed under Section 720 (relating to inadmissible assets).

Section 716—Average Invested Capital

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

Section 717—Daily Invested Capital

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day, plus the borrowed invested capital for such day determined under Section 719.

Section 718—Equity Invested Capital

(a) Definition. The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) Money paid in . . . (not involved in this case)

(2) Property paid in . . . (not involved in this case)

(3) Distributions in stock . . . (not involved in this case)

(4) Earnings and profits at beginning of year. —The accumulated earnings and profits as of the beginning of such taxable year.

(Balance of Section 718 not involved in this case.)

Section 719—Borrowed Invested Capital

(a) Borrowed capital. The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer

which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

(2) (3) and (4)—not involved in this case.

(b) Borrowed Invested Capital. The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

REGULATIONS INVOLVED.

Treasury Department Regulations 112
Relating to the Excess Profits Tax.

Sec. 35.718-2. *Determination of daily equity invested capital.—Accumulated earnings and profits.*—(a) *In general.*

The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. As to determination of additional amount to be included in daily equity invested capital on account of new capital, see section 35.718-4. In computing accumulated earnings and profits as of the beginning of the taxable year, a tax-

payer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit. Unrealized appreciation in value of property is not a factor in determining earnings and profits.

Sec. 35.719-1. *Borrowed Invested Capital.*

The borrowed invested capital for any day of the taxable year is 50 percent of the borrowed capital for such day determined as of the beginning of such day. Borrowed capital is defined to mean:

(a) Outstanding indebtedness (other than interest, but including indebtedness assumed or to which the taxpayer's property is subject) of the taxpayer which is evidenced by a bond, a promissory note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus

* * * * *

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose

an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

The term "certificate of indebtedness" includes only instruments having the general character of investment securities issued by a corporation as distinguishable from instruments evidencing debts arising in ordinary transactions between individuals. Borrowed capital does not include indebtedness incurred by a bank arising out of the receipt of a deposit and evidenced, for example, by a certificate of deposit, a passbook, a cashier's check, or a certified check.

Treasury Department Regulations III.

Sec. 29.115-3. Earnings or profits.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere book-

keeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the case receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation,

is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

Sec. 29.115-12. Effect on earnings and profits of gain or loss realized after February 28, 1913.—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115(1) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but dis-

regarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see section 29.115-3). Under both (1) and (2) the adjusted basis is subject to the limitations of the third sentence of section 115(1) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under (1) and (2) of section 115(1) depending upon the basis to which the adjustments are to be made. If the application of (2) of the first sentence of section 115(1) results in a loss and if the application of (1) of such sentence to the same transaction reaches a different result, then the loss under (2) will be subject to the adjustment thereto required by section 115(m)(2). (See section 29.115-14.)

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. A loss (other than a wash sale loss with respect to which a deduction is disallowed under the provisions of section 118 or cor-

responding provisions of prior revenue laws) may be recognized though not allowed as a deduction (by reason, for example, of the operation of sections 24 (b) and 117 and corresponding provisions of prior revenue laws) but the mere fact that it is not allowed does not prevent decrease in earnings and profits by the amount of such disallowed loss. Wash sale losses, however, disallowed under section 118 and corresponding provisions of prior revenue laws, are deemed non-recognized losses and do not reduce earnings or profits. The "recognized" gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(1) as distinguished from the realized gain or loss used in computing net income. The application of this paragraph may be illustrated by the following examples:

* * * * * * *

Appendix B

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,* vs. PACIFIC AFFILIATE, INC., a corporation, *Respondent.*	No. 14,111 Jul. 20, 1955
PACIFIC AFFILIATE, INC., a corporation, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

Petitions to Review a Decision of the Tax Court of the United States

BEFORE: HEALY and POPE, Circuit Judges, and LINDBERG, District Judge

PER CURIAM

This is an appeal from a decision of the Tax Court, 18 T. C. 1175, in a case involving the excess profits tax statute. The Court sustained certain of the Commissioner's deficiency assessments and overruled others. Both the taxpayer and the Commissioner have appealed.

The decision below was by the full membership of the Court and was without dissent except as to one relatively minor matter. It represents a well-considered effort to resolve points all of which are debatable. We are not persuaded that the Court was wrong in any particular.

One matter, however, should be noticed specifically. A question ruled on by the Court was whether the Commissioner erred in reducing invested capital, as of the beginning of 1944, by the amount of income and excess profits tax deficiencies determined therein for the year 1943. The Court in upholding the Commissioner in this respect adhered to its earlier ruling in Stern Brothers & Co., 16 T.C. 295. It is suggested that doubt may be cast on the validity of that ruling by the recent decision in Lewyt Corporation v. Commissioner, ... U.S. ....., handed down May 23, 1955.

In Stern Brothers & Co. the Tax Court recognized and considered the contention urged by the taxpayer here. It held that the rule announced and followed in Dixie Pine Co. v. Commissioner, 320 U.S. 516, and Security Mills Co. v. Commissioner, 321 U.S. 281 that a tax which is being contested does not accrue until liability therefor is finally determined was not applicable when the purpose of the accrual of the tax is to reflect the amount of a corporation's accumulated earnings and profits at the beginning of a taxable year for invested capital credit purposes. Judge Hill, in writing for the Tax Court, stated:

> "Petitioner's argument is based upon a *failure to distinguish the accrual of Federal income and*

excess profits taxes called for by Regulations 112, section 35.718-2(a) from the more usual accrual for purposes of deduction from, or inclusion in, income. The accrual of these taxes results in no deductible expense in computing taxable income. The sole reason for the accrual of such taxes is to properly reflect the amount of a corporation's accumulated earnings and profits at the beginning of a taxable year for invested capital credit purposes. If accumulated earnings and profits at the start of any taxable year are to show the true financial status of an accrual basis taxpayer, an adjustment must be made for income and excess profits taxes arising in the preceding year. Thus the accrual called for by this subsection of the Regulations is simply an adjustment to accumulated earnings and profits.

"To effectuate the required adjustment, income and excess profits taxes must be accrued by an accrual basis taxpayer in the year they arose regardless of whether its liability therefor became definite and ascertainable in amount in that year or a subsequent year. The fact that liability for either or both taxes is contested does not postpone accrual of liability to a later year. To hold otherwise and invoke the rule that a contested tax is accruable only in the taxable year when liability is finally determined would completely defeat the purpose of the Regulation. Thus by simply contesting liability for income and excess profits taxes a taxpayer could postpone their accrual until after the year in which they arose, and its accumulated earnings and profits for the succeeding year would never be diminished by the amount of these taxes." [Emphasis supplied.]

Lewyt, supra, in no respect challenges the distinction made by the Tax Court. In Lewyt the Supreme Court affirmed the Court of Appeals so far as it followed the rule of Dixie Pine Co. v. Commissioner, supra, and Security Mills Co. v. Commissioner, supra. The primary issue involved in the tax litigation there was the interpretation and application of 26 U.S.C. §122(d)(6) in computing net operating loss *deductions from income.* The opinion of the Supreme Court in reversing in part the decision of the lower court as well as the dissenting opinion of Justice Frankfurter clearly indicates that the decision should be narrowly confined to an interpretation of the *statutory language* of said section 122(d)(6) of the Internal Revenue Code. We are of the opinion that the decision does not lessen the validity of the distinction made by the Tax Court in not applying the rule of Dixie Pine Co. and Security Mills Co., supra, when dealing with the accrual of federal income and excess profits taxes called for by Treasury Regulation 112, Section 35.718-2(a).

Accordingly, on the grounds and for the reasons given by the Tax Court, its order is affirmed.

(Endorsed:) Per Curiam Opinion. Filed Jul. 20, 1955. Paul P. O'Brien, Clerk.

Appendix C

United States Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,* vs. PACIFIC AFFILIATE, INC., a corporation, *Respondent.*	No. 14,111
PACIFIC AFFILIATE, INC., a corporation, *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

JUDGMENT

Upon petitions to Review a Decision of the Tax Court of the United States.

This cause came on to be heard on the Transcript of the Record from the Tax Court of the United States, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court of the United States be, and hereby is affirmed.

(ENDORSED) Judgment

Filed and Entered: July 20, 1955
PAUL P. O'BRIEN, Clerk.

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 605

PACIFIC AFFILIATE, INC., A CORPORATION,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 24–71) are reported at 18 T. C. 1175. The supplemental opinion of the Tax Court (R. 71–72) is not officially reported. The opinion of the Court of Appeals (Pet. App. B) is reported at 224 F. 2d 578.

JURISDICTION

The judgment of the Court of Appeals was entered on July 20, 1955 (R. 245), and a petition for rehearing was denied December 1, 1955 (R.

246). The petition for a writ of certiorari was filed on January 4, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. Whether the court below erred in holding that the amount of taxpayer's income and excess profits tax liabilities for 1943 as finally determined in this proceeding must be accrued as of December 31, 1943, and deducted from taxpayer's 1943 income in computing the amount of its accumulated earnings and profits to be included in its equity invested capital as of January 1, 1944, under Section 718 (a) (4) of the Internal Revenue Code of 1939.

2. Whether the court below erred in holding that only 50 percent of two loans constituted "borrowed capital" of taxpayer within the meaning of Section 719 (a) (1) of the Code because the loans were obtained and used partially for the benefit of another corporation.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 718 [As added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.
>
> (a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following

amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—* * *

(2) *Property paid in.*—* * *

(3) *Distributions in stock.*—* * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year; and

* * * * *

(26 U. S. C. 1952 ed., Sec. 718.)

SEC. 719 [As added by Sec. 201 of the Second Revenue Act of 1940, *supra,* and amended by Sec. 230 (b) (2) of the Revenue Act of 1942, c. 619, 56 Stat. 798].

BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

* * * * *

(b) *Borrowed Invested Capital.*—The borrowed invested capital for any day for any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

(26 U. S. C. 1952 ed., Sec. 719.)

Treasury Regulations 112, promulgated under the excess profits tax provisions of the Internal Revenue Code of 1939:

> SEC. 35.718–2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718–5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. * * * In computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year. * * *
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> SEC. 35.719–1. *Borrowed Invested Capital.*—
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> In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it

ceases to be borrowed capital of the taxpayer. For such purpose an assumption of indebtedness includes the receipt of property subject to indebtedness.

* * * * *

STATEMENT

The Commissioner determined deficiencies in taxpayer's income and excess profits taxes for 1943 and 1944 which taxpayer contested in the Tax Court on a number of grounds relating to the proper computation of its net income and excess profits tax credit for those years. (See R. 25–27.) The Tax Court decided some issues in taxpayer's favor and some in favor of the Commissioner. (R. 50–72.) Taxpayer appealed on three issues and the Commissioner on two issues. (See R. 84–99.) The Court of Appeals affirmed the Tax Court on all issues. (Pet. App. B.)

The facts bearing on the two issues presented in taxpayer's petition to this Court may be restated as follows:

Question 1

It is conceded by both parties (1) that one of the factors to be taken into consideration in computing taxpayer's invested capital for excess profits tax purposes for 1944 is the amount of taxpayer's "accumulated earnings and profits" as of January 1, 1944 (see Sec. 718 (a) (4) of the Internal Revenue Code of 1939, *supra,* p. 3);

and (2) that, since taxpayer filed its returns on the accrual basis of accounting (R. 27), the computation of its accumulated earnings and profits as of January 1, 1944, is to be made by subtracting the amount of its income and excess profits taxes for 1943 (see Treasury Regulations 112, Sec. 35.718–2, *supra,* p. 4). The question is what amount is to be subtracted as its income and excess profits taxes for 1943. Taxpayer contends that the amount to be subtracted is the amount it reported on its return, whereas the correct amount is being determined in this case by the resolution of other issues. The parties stipulated (R. 105) that—

> (f) In computing invested capital for 1944 the correct income and excess profits tax liability for 1943 shall be taken into account as an accrued liability as of December 31, 1943 * * * if as a matter of law they must be accrued as of December 31, 1943.

The Tax Court (R. 71–72) and Court of Appeals (Pet. App. B) both held that the amount of taxpayer's income and excess profits taxes for 1943 as determined in this proceeding is to be accrued as of December 31, 1943.

Question 2

The Tax Court's findings on this issue (R. 32–37) may be briefly summarized as follows:

The issue involves two $19,800,000 loans evidenced by notes signed by taxpayer. Each loan

was used for the purpose of making an original subscription for $20,000,000 of two per cent United States Treasury bonds. (R. 32–33, 35.)

The first $19,800,000 loan was made by Guaranty Trust Company of New York on April 19, 1943, after taxpayer's obligation for the subscription to $20,000,000 in bonds had been carried by Bank of America for four days. The Guaranty Trust loan was arranged by Blair Securities Company, a business associate of taxpayer, which had previously suggested the investment to taxpayer. For the bonds, taxpayer paid the proceeds of the Guaranty Trust loan plus $200,000 cash to the Federal Reserve Bank. Between April 19 and May 14, 1943, taxpayer made sales of the bonds, finally disposing of the entire amount. Prior thereto, taxpayer maintained on its books a special account with Blair for these transactions. In that account taxpayer made monthly charges for 50 per cent of the interest paid to the banks for carrying the bonds and every few days entries were made crediting to the accounts interest at the coupon rate which accrued on 50 per cent of the bonds. During the period it held the bonds, taxpayer paid a total of $10,855.97 in interest to the banks and collected interest income of $27,010.84 on the bonds, making a net of $16,154.87 of interest received over interest expense. On May 20, 1943, after disposition of all the bonds, taxpayer paid Blair $8,077.44 by letter of trans-

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mittal enclosing its check for "one-half of the net interest earned on the $20,000,000 U. S. Treasury 2% Bond account" and "an itemized statement of this account". Blair acknowledged the check and itemized statement in the same language. In addition to the net interest, taxpayer realized a profit from the sales of the bonds in the total amount of $41,875, which it kept for itself. (R. 32–35.)

In September 1943, when the Treasury again issued bonds, taxpayer and Blair again agreed to a transaction similar to the prior one, and, in addition, the agreement provided for the sharing of profits on the bonds. Taxpayer made the subscription for $20,000,000 of bonds under date of September 15, 1943, through the Bank of America. It paid $200,000 cash and borrowed $19,800,000 from that bank on its promissory note. Blair paid $100,000 to taxpayer to be used in making the $200,000 cash payment. When taxpayer received this $100,000 from Blair it recorded the receipt on its books by crediting $100,000 to its Blair account. As in the case of the previous loan, taxpayer maintained a special account with Blair for these transactions and in that account debited Blair with 50 per cent of the interest paid to carry the bonds and credited Blair with 50 per cent of the interest which accrued on the bonds. (R. 35–36.)

On November 16, 1943, $10,000,000 of the par value of these bonds were sold to the Bank of

America at a profit of $9,375. On the same day taxpayer authorized the bank to credit $100,000 of the proceeds of the sale to the account of Blair and on its books taxpayer charged the Blair account with this amount, wiping out the $100,000 previously credited to the account. (R. 35.)

Taxpayer wanted to close the joint account and carry the remaining $10,000,000 of bonds free of its arrangement with Blair. Up to that time the net interest return on the bonds was $34,031.68. Taxpayer settled the joint account by paying Blair one half of the net interest ($17,015.84) and also the entire profit on the sale of the $10,000,000 of bonds ($9,375), a total of $26,390.84. Taxpayer's letter of transmittal to Blair enclosed taxpayer's check for $26,390.84 as "representing your share of the interest earned and profit in the $20,000,000. United States Treasury 2% Bonds Joint Account" and also "an itemized statement of the Account". Blair acknowledged the check in the same language. (R. 36.)

The Tax Court held that only 50 per cent of the two $19,800,000 loans is includible in taxpayer's borrowed invested capital under Section 719 of the Code for the purpose of computing taxpayer's excess profits credit by the invested capital method (R. 59–61). The Court of Appeals affirmed without discussion of the issue (Pet. App. B).

ARGUMENT

The petition presents two separate questions. Taxpayer claims that the decision below on the

first question, involving the accrual of contested federal tax liability for purposes of determining taxpayer's excess profits tax invested capital credit, is in conflict with various decisions of this Court. As we show below, there is no conflict with the cited decisions, which deal with the accrual of contested tax liability for other and different purposes. The decisions below, moreover, apply a rule which is reasonable in result and consistent with the requirements of the taxing statute. Similarly the second question, which is primarily one of fact and of no general importance, was correctly decided by the two courts below. There is no occasion, therefore, for further review of this case by this Court.

1. The first question relates to the accrual of federal excess profits taxes for 1943 for the purpose of computing taxpayer's 1944 excess profits tax credit, which, roughly speaking, is eight per cent of its "invested capital" for 1944. Taxpayer's "invested capital" for 1944 includes the amount of its "accumulated earnings and profits" at the beginning of that year (Sec. 718 (a) (4) of the 1939 Code, *supra,* p. 3), in the computation of which taxpayer's excess profits tax for the preceding year, 1943, is to be subtracted (Treasury Regulations 112, Sec. 35.718–2, *supra,* p. 4) as having accrued in 1943. In this proceeding taxpayer has been litigating various issues the resolution of which will determine the *correct* amount of its 1943 excess profits tax. The court

below (Pet. App. B), like the Tax Court before it (R. 71–72), held that the correct amount of taxpayer's 1943 excess profits tax, as ultimately determined in this proceeding, is to be subtracted in computing taxpayer's accumulated earnings and profits as of January 1, 1944, rather than, as taxpayer contends, the amount of excess profits tax it reported on its 1943 return.

That holding does not appear to be in conflict with this Court's decisions in *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, or *Security Mills Co.* v. *Commissioner,* 321 U. S. 281. Both of these cases involved a claimed deduction from income and it was in that setting that the Court held that, like any other contested expenses, a contested tax does not accrue until the controversy is settled. The present case involves federal taxes, which not only are not deductible as an expense but are computable on an annual basis. There are decisions of this Court which point to a conclusion that the *correct* amount of such taxes in any given year accrues in that year provided, as here, the events on which the tax liability is determined for that year all occurred in that year. See *United States* v. *Anderson,* 269 U. S. 422, 441; *Manning* v. *Seeley Tube & Box Co.,* 338 U. S. 561, 565, 567; *United States* v. *Koppers Co.,* 348 U. S. 254. Moreover, in at least one situation this Court has held that the correct amount of a federal tax liability "accrued" in the taxable year even though liability in that

amount was neither fixed nor ascertainable in that year. *Fawcus Machine Co.* v. *United States,* 282 U. S. 375.

In the present case the accrual question has relation to an adjustment to accumulated earnings and profits for the year in question for excess profits tax credit purposes. As the courts below held, this adjustment must be made to reflect the tax liability as ultimately determined if the true financial status of an accrual basis taxpayer as of the start of the succeeding taxable year is to be shown. As the court below said (Pet., App. B, xii), quoting *Stern Brothers & Co.* v. *Commissioner,* 16 T. C. 295, 323:

> * * * To hold otherwise and invoke the rule that a contested tax is accruable only in the taxable year when liability is finally determined would completely defeat the purpose of the Regulation. Thus by simply contesting liability for income and excess profits taxes a taxpayer could postpone their accrual until after the year in which they arose, and its accumulated earnings and profits for the succeeding year would never be diminished by the amount of these taxes. * * *

In other words, in the case of a claimed deduction from income, there would be a distortion of income if a contested liability, which might never materialize, were accrued as a fixed liability and deducted from income. In the present case a distortion of income will result from a failure to

accrue in the earlier year the correct amount of the excess profits liability, as ultimately determined in this proceeding.

The excess profits tax credit has relation to the size of a business and represents the amount which the business should be permitted to earn as normal earnings free of the excess profits tax. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, 497–498. As the whole scheme of the excess profits tax statutes shows, that amount is to be determined on the basis of events prior to (and perhaps within) the taxable year for which the excess profits tax is being computed. The present issue involves the computation of the excess profits tax credit for 1944 as related to taxpayer's excess profits tax liability for 1943. The 1943 tax liability results from the events and transactions of 1943 and thus it is the *correct* amount of the 1943 tax liability which attached in and was a liability of 1943, regardless of the fact that a portion of it has been the subject of controversy. If the correct amount as determined in this proceeding is not subtracted in computing taxpayer's accumulated earnings and profits (and thus invested capital) as of January 1, 1944, the portion of the tax liability which was contested will be treated as earnings and profits of 1943, with a resulting increase in the excess profits tax credit for 1944. Treating the contested portion of the actual, ultimately determined 1943 tax liability as accumulated earnings and profits, with a resulting increase in the excess

profits tax credit, is artificial and results in a distortion of the income which Congress intended to subject to the excess profits tax.

It may further be noted that, unlike the situation in *Dixie Pine* and *Security Mills,* the contest as to tax liability is in this very proceeding, rather than in an independent proceeding, and is based on issues, the resolution of which will be given effect in determining petitioner's federal income and excess profits tax liability for 1943. It is reasonable to suggest that the necessary consequence of the adjustment of taxpayer's tax liability for 1943, thus determined, should also be given effect by reflecting taxpayer's correct tax liability in determining its excess profits tax credit for the succeeding years. Indeed the rationale of the *Dixie Pine* and *Security Mills* cases appears to have been that a taxpayer should not be able to contest a tax liability and at one and the same time secure a tax benefit by deducting the contested tax from income as a fixed liability. In the instant case taxpayer would secure a tax benefit by *not* accruing the contested tax in the taxable year. The failure to subtract the correct amount of tax liability in computing accumulated earnings and profits increases the amount of taxpayer's invested capital, and thus its excess profits credit, and reduces its taxes. That is true not only for 1944, the only taxable year on which the issue has a bearing in this proceeding, but

for 1945 and for the years beginning with 1950[1] and continuing until the decision in this case becomes final. Thus the decision below, far from being in conflict with *Dixie Pine* and *Security Mills,* is consistent with, if not required by, the rationale of those decisions.

Like the court below (Pet. App. B), we do not regard the decisions below as in conflict with *Lewyt Corp.* v. *Commissioner,* 349 U. S. 237. That case involved the excess profits tax carry-back and, accordingly, not only a deduction from income but a deduction claimed on the basis of events which occurred subsequent to the controverted year of accrual. As we interpret it, the decision is based on the view that "Events and transactions of later years" (p. 243) are irrelevant to a determination of income on the accrual basis. That the decision was intended to be so limited seems evident from the Court's reference to its prior holding that the excess profits tax is payable "in full" the year when due (p. 242) and its statement that the amount of tax accrued under the statute there involved, determined in accordance with normal accounting concepts, "is not, of course, to be ascertained solely by reference to the figure set forth in the taxpayer's return, for that figure may be erroneously computed on the accrual basis" (p. 243). In the

[1] The excess profits tax was not in effect in the years 1945 to 1949, inclusive.

present case the tax liability held to be accruable by the court below in no way involves events or transactions subsequent to 1943. The tax has been computed on the basis of the events and transactions of 1943 and the question is only as to what amount should be accrued in 1943 as taxpayer's 1943 excess profits tax liability for the purpose of computing taxpayer's excess profits tax credit—the correct amount as ultimately determined in this proceeding or the erroneous amount which taxpayer reported on its return.

The other conflicts of decisions asserted by taxpayer require little discussion. *United States* v. *Olympic Radio & Television,* 349 U. S. 232, held only that the excess profits tax for a given year accrues in that year and cannot be deducted by an accrual basis taxpayer in the following year of payment in computing the net operating loss of that following year. The other issue in *Lewyt Corp.* v. *Commissioner,* 215 F. 2d 518 (C. A. 2d), on which certiorari was not granted, did not involve the accrual of excess profits taxes as of the years the tax liabilities incurred. The remark of the court of appeals quoted by taxpayer (Pet. 17) was dictum, unnecessary to its decision. The issue there was whether there was a payment in 1947 of contested tax liabilities involving prior years so as to justify the accrual of those liabilities in 1947. The Second Circuit held that there had

been no payment of the tax liabilities in 1947, and that accordingly they could not be accrued in that year.[2]

We conclude that the courts below correctly held that taxpayer's invested capital credit for 1944 should be determined on the basis of its true tax liability for 1943, not on the basis of the amount returned by taxpayer in its 1943 return.

2. Contrary to taxpayer's assertions (Pet. 10–11, 29), the second question presented in the petition is not an important one requiring the exercise of this Court's power of supervision.

The court below, by affirming the Tax Court's decision on the second issue (R. 59–60), held in effect that the two $19,800,000 loans taxpayer obtained to purchase United States Treasury bonds constituted "outstanding indebtedness * * * of the taxpayer" within the meaning of Section 719 (a) (1) of the Code, *supra,* p. 3, only to the extent of 50 per cent of the amount of the loans, because the loans were obtained partially for the benefit of another corporation. Taxpayer attacks the exclusion of 50 per cent of the loans from its borrowed capital, arguing that, literally, the loans *in toto* constituted taxpayer's indebtedness (Pet. 25–28). The argument ignores the well established rule that statutory language should be construed so as to give effect

[2] *Campana Corp.* v. *Commissioner,* 210 F. 2d 897 (C. A. 7th), also cited by taxpayer (Pet. 13), involved excise taxes.

to the intent of Congress and in accordance with the policy of the legislation as a whole. *United States* v. *Amer. Trucking Assn's,* 310 U. S. 534, 542, 543–544; *Ozawa* v. *United States,* 260 U. S. 178, 194. Congress intended the excess profits credit to represent the normal earnings of the taxpayer which are free from the excess profits tax and that the credit should be based on the taxpayer's invested, or operating, capital (*Commissioner* v. *South Texas Co.,* 333 U. S. 496, 497–498), which includes the borrowed capital as defined in Section 719 (a) (1) to the extent includible in borrowed invested capital under Section 719 (b), *supra,* p. 3. Consistently with the Congressional purpose, the word "indebtedness" in Section 719 (a) (1) should be interpreted, as it was by the courts below, as excluding that portion of the borrowed money from which another corporation receives the benefit. See *Hart-Bartlett-Sturtevant G. Co.* v. *Commissioner,* 182 F. 2d 153 (C. A. 8th); *Mahoney Motor Co.* v. *Commissioner,* 192 F. 2d 508, 511 (C. A. 8th); Treasury Regulations 112, Sec. 35.719–1, *supra,* p. 4. Taxpayer argues that the allowance of only 50 per cent of its two loans as borrowed capital is arbitrary (Pet. 26). On the contrary, since in accordance with its arrangement with Blair, taxpayer paid over to Blair 50% of the net interest earned, this allocation had a basis in fact. The judgment of the two lower courts on this factual question should not be disturbed. *Corn*

Products Refining Co. v. *Commissioner,* 350 U. S. 46, 51; *Comstock* v. *Group of Investors,* 335 U. S. 211, 214.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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